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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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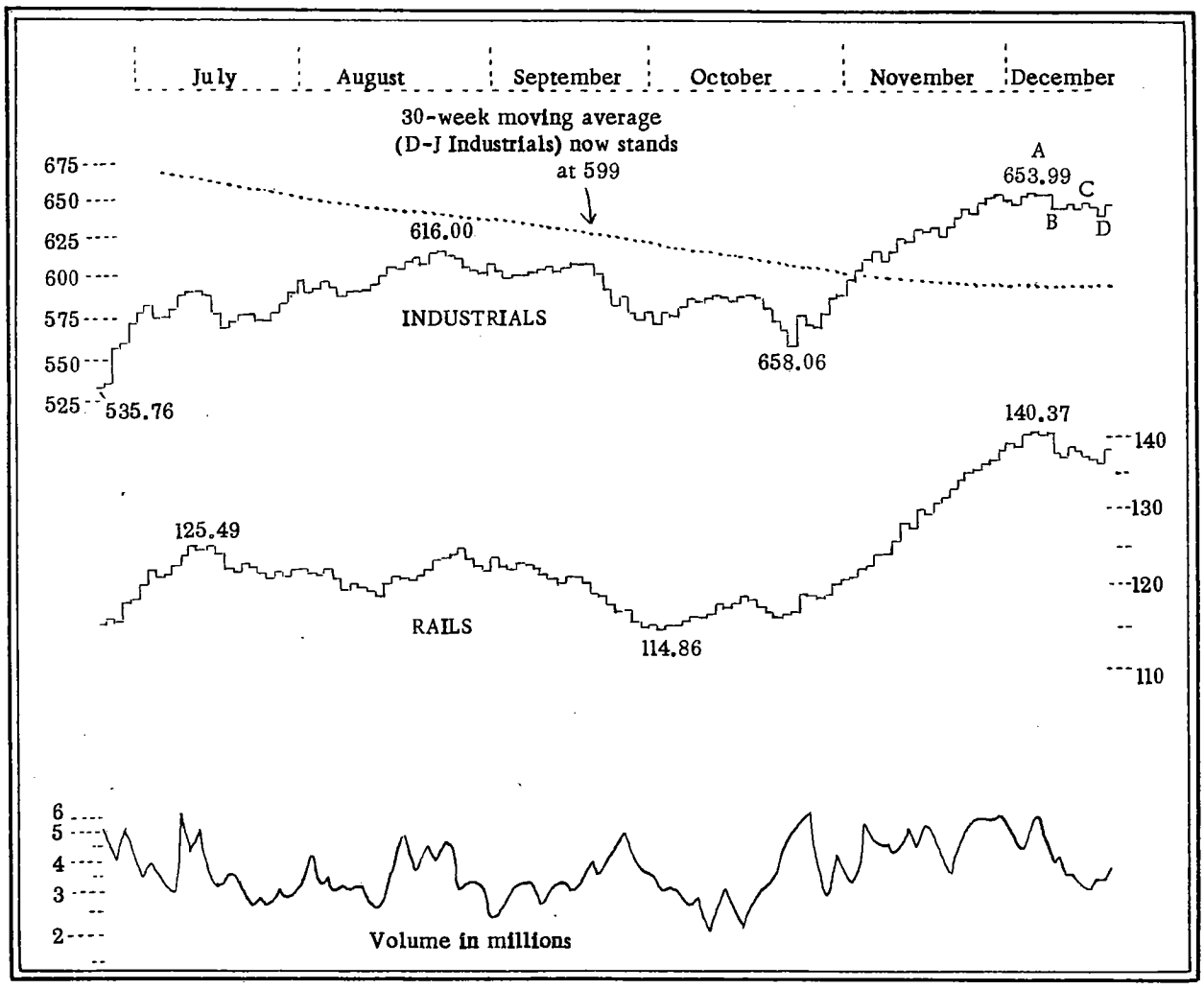
THE MARKET The last Letter (203) called attention to the "rounding-over" pattern in Industrials, a pattern which came in the face of almost unanimously bullish professional opinion. The steady odd-lot selling and the record-low figures (around 7%) for odd-lot trading (as a percentage of total exchange trading) have suggested to most market analysts that this is "another 1958". Recent odd-lot statistics also suggest that it was even-lot ("smart") buying that moved the market up from the June lows. Since 1949 "professional rallies" have always ended with the "public" coming in and carrying the ball while the professionals fed out their stock to the tune of increasing prices. Is this the picture we face again today?

Perhaps, but the history of odd-lot trading following crashes suggests that at least one other possibility exists. For instance, odd-lot participation as a percentage of total trading dropped steadily from mid-1938 (20%) to a low of 7% in 1943. This loss of interest by the public followed the 1937 crash. Again, subsequent to the 1946 crash, odd-lot participation receded from a high of 15% (late 1946) to a 1951 low of 7%. All of which suggests that following crash-action, it may take several years before the public is willing to become active in the market again.

The rise from the October lows (see chart) succeeded in generating heavy trading volume. Around mid-November (see last Letter) "churning" action became evident as the heavy volume began to exert less and less "lifting power" on the market. On December 6 volume suddenly contracted. Since that time, prices have settled back to the accompaniment of dwindling



 volume. Thus, two weeks after the appearance of churning, the buyers have stopped buying.

Last week (week ending December 4) saw 903 stocks decline and 448 stocks advance. This constitutes a fairly sharp decline in "breadth". It also indicates broad profit-taking under the guise of "holding action" in the Averages.

As noted in the last Letter (202), few movements with the momentum of this one have ended without the appearance of some sort of "danger signal" in the Averages. Such signals usually consist of (1) persistent divergence between the two Averages (one Average advances while the other declines), or (2) a rise by one Average to a new recovery high — with the other Average refusing to confirm.

On December 5 the two indicators rose to joint recovery highs (Industrials 653.99, Rails 140.37). Then, on December 10 (with no prior non-confirmation or divergence) both Averages suddenly turned down and broke below their range of the preceding two weeks. An unimpressive rally followed, and on December 18 the two Averages again broke to new lows for the move. Thus both indicators have now traced descending zig-zag structures (A-B-C-D on chart).

Volume showed no particular tendency to expand on the decline, and this suggests the possibility of a final rally to or above the December 5 highs. If, on such a rally, one or both Averages fail to better the preceding peaks, and the two indicators then turn down on increasing volume, I would take the action to be extremely ominous.

In the absence of a new high by one or both Averages, immediate trouble would be indicated by a series of descending zig-zags — with volume tending to expand as the price level recedes.

On the decline since December 5, the market (as represented by the A-D ratio) did noticibly poorer than the Industrial Average. In fact, many of the Dow stocks held quite well in the face of a retreat by the majority of lesser-grade issues. This suggests that the Industrial Average will show more "lifting power" than the rest of the market on any rally from this area. A new high by Industrials in the face of a lagging "general market" would also be a danger signal worth watching.

Personally, I feel that whether a significant rally materializes from these levels or not, the "market" is essentially "tired." The over-bought condition which was discussed in the past two Letters is still in effect. When this has occurred in the past, the odds favored a lengthy consolidation period or an important decline. The latter has usually developed following a rally in which one Average advanced to a new recovery high — unconfirmed by the other.

FROM THE VIEWPOINT OF THE LONG-TERM (PRIMARY TREND) INVESTOR The last confirmed lows of the bear market were recorded on June 26, 1962. The usual three bear market phases had not appeared prior to that date, and those who bought for investment purposes at or near the June lows were doing so on other than Dow Theory implications. Contrary to public opinion, neither Hamilton nor Rhea ever suggested waiting for a bull signal before taking long-term positions. However, both of these men did advocate taking positions when a bear market appeared to be in its third or final phase and when the price structure was working sideways to the accompaniment of extremely low volume (such action being typical of a bear market bottom).

In 1934 Rhea observed: "It has always seemed to me that the accumulation period around the end of a bear market is easier to detect than the distribution at the termination of bull periods. At, or near, the end of a bear market, trading shows a uniform tendency to average less than at any time since the beginning of the primary downward movement. The Averages reflect completed liquidation and lack of speculative enthusiasm by a sideways drag. Both rallies and declines become sluggish. Somewhere near the bottom, a 'line' is usually formed."

As to waiting for an actual bull market signal before buying, Rhea made the following comment in November, 1932: "Hamilton did not wait for such (bull market) confirmations as a general thing. He weighed the action of the Averages and volume of trading; he considered past movements and then expressed his opinion."

Again in June, 1933, Rhea wrote: "Old students of the Averages know that Hamilton generally advised his readers to buy very close to the bottom. His reasons for doing so were explained by the movements of the Averages. If we do this, and then carry our stocks through the final confirmation point (i.e., the bull signal), then this final confirmation merely tells us that we are right."

Referring to the current situation, during June-October, 1962, none of the characteristics of a major bear market bottom were visible in the price structure or in volume. Moreover, the average Industrial yield of 4.2% (June, 1962) did not provide the usual suggestion of "values" at a bear market bottom. There was little in the mid-1962 picture to cause a Dow Theorist to accumulate stocks for a new bull market. Nevertheless, a substantial rise has occurred from that area.

On November 9 the two Averages hurdled their preceding secondary peak, thereby providing a mechanical "bull signal." This writer was (and has remained) sceptical regarding the probability of a true bull market's developing from the June, 1962 lows, and in Letter 200 statistics were included covering four other instances when (following crashes) mechanical bull signals were given.

The four instances cited were February, 1930, June, 1938, July, 1939 and May, 1948. It was stated that following these four mechanical bull signals, the appreciation in the Industrial Average amounted to 12%, 25%, 8% and 4% respectively. Furthermore, following each of the mechanical bull signals, the length of time which elapsed before the "new bull market" terminated was two months, five months, two months and one month, respectively.

Since bettering their August 23, 1962 secondary peak of 616.00, Industrials have advanced to a December 5 recovery high of 653.99. This represents a rise of 38 points or 6.2% following the "bull signal" of November 9.

Obviously, those who were smart enough or lucky enough to buy near the lows of June or October should now be showing profits on balance. However, those who purchased on or after the November 9 signal because they believed that that action represented a confirmation of a reversal of trend from bear to bull have little (so far) to show for their money. If we are in a true bull market, then purchases executed on or after the "bull signal" of November 9 will, in all probability, turn out to be profitable. On the other hand, if the rise since June, 1962, is (as I suspect) part of typical post-crash recovery action, purchases executed on the November 9 signal will probably bring more worries than rewards.

It is worth noting that the average yield on Industrials is now 3.5%, and the price-earnings ratio on the senior Average is now 18.8. By historical standards, the stocks that make up the Industrial Average are rather richly valued only one month after the "new bull market signal."

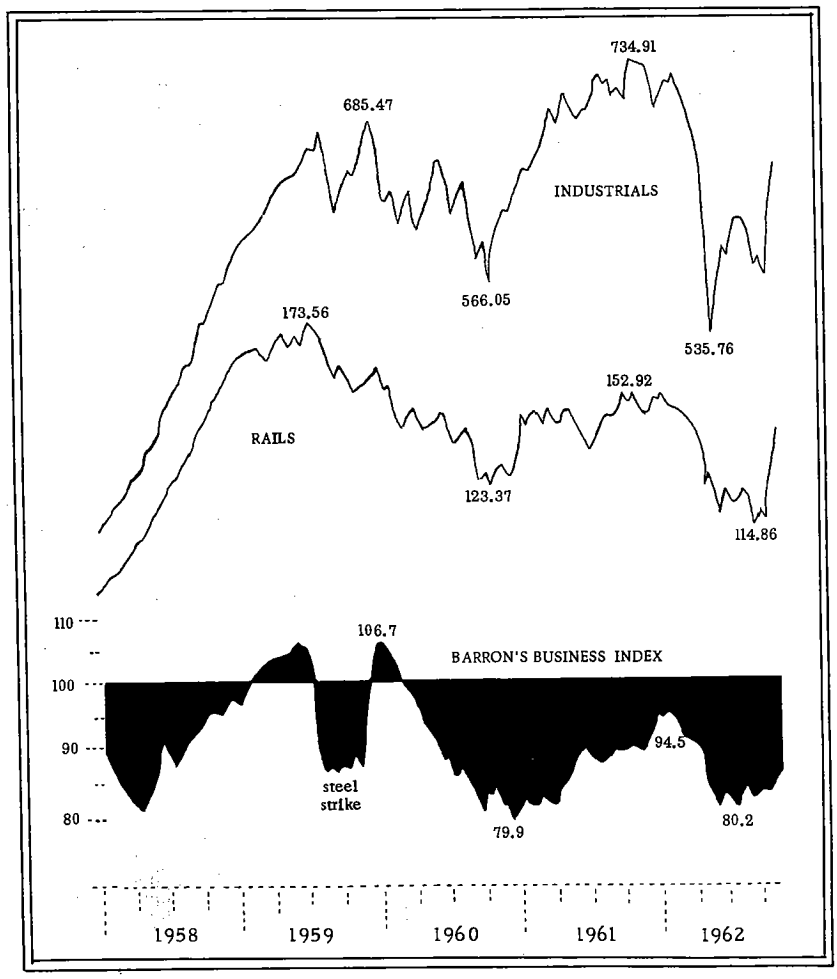
THE AVERAGES AND BUSINESS Many readers of these Letters are working businessmen. These subscribers are often more concerned with the trend of business, as implied by the major movements of the market, than with the trend of stocks themselves. For this reason, I have made it a practice to include periodic comments concerning the market and its predictive value. History shows that few periods of business expansion and contraction have occurred without prior "signals" from the Averages. In view of this, it may be instructive to analyze the current picture in terms of the Averages and one of our oldest indices of the economy, Barron's Business Index.

As noted in many previous Letters, Barron's Business Index tends to be an index of heavy industry. The index includes statistics for carloadings, steel activity, petroleum output, coal production and electric power, all adjusted for seasonal and population trends. Since it is the "heavy stuff" which tends to swing the economy in and out of recessions, my own opinion is that Barron's Index is an important indicator of cyclical contraction or expansion.

The accompanying chart traces the great market rise of 1958-59 and the rise of Barron's Index (interrupted by the steel strike) to a January, 1961 peak of 106.7. The subsequent major market decline predicted the subsequent decline of Barron's Business Index (it fell to a December, 1960, low of 79.9). The short-lived 1960-61 market advance was followed by an expansion in Barron's Index to an early 1962 peak of 94.5. It is interesting to note the sub-standard performance of the Rails during 1960-61, and the sub-standard expansion in the economy. The 1962 peak in Barron's Index was 14% below the 1960 peak.

The bear market of 1962 was accompanied by a 15% drop in Barron's Business Index (94.5 to 80.2). The Averages recorded their last confirmed lows on June 26. During the week of July 30 (a month later), Barron's Index struck a low of 80.2.

From its July, 1962 low of 80.2, Barron's Index has risen to a recent peak (December 10) of 86.3, a rise of 7% for the Index five months after its bear market low. A 7% rise five months from the low constitutes a sluggish recovery. In fact, in the face of (1) at least a temporary bottom and turn-up on Barron's Index, and (2) a violent market rise, it is one of the poorest Index performances of the last decade.



Mr. James Hughes of New York has kept detailed records of the relationship of the Industrial Average, the majority of stocks (advance-decline ratio) and bank credit trends. Writing recently of the January-June, 1962 action, Hughes states: "From the viewpoint of the stock market's relations to banking trends, the May-June collapse was completely without precedent." In other words, little or nothing in the banking figures suggested a 27% drop in the Industrial Average and the most concentrated two-month collapse in the A-D ratio since 1929.

The nation's economy has held fairly well during and since the market drop. For this reason, the majority of analysts are now increasingly willing to "write-off" the early 1962 market action as "nothing more than a period of adjustment." This writer remains sceptical. There have been times when the market has discounted changes by as much as a year in advance. The Averages look ahead, and they have a habit of discounting anything which may have a forthcoming effect upon business. The "anything" can be economic, social, political or psychological. I am not yet convinced that the 1962 collapse was a mere "revision of speculative sentiment." What the market was "protecting itself against" when it crashed is not yet evident. I would prefer to give the situation more time before concluding that it was all a "mistake."

LATE NOTES (Written Wednesday, December 20, noon, N.Y. time). On December 19 Industrials rose almost 7 points, Rails over a point. The A-D ratio lagged noticibly with only 234 more advances than declines. It is of interest that with Industrials less than 5 points from their December 5 peak, the A-D ratio is now below its August peak (at which time the Industrial Average stood at 616.00).

My guess is that a rise to or above the December highs will be accompanied by heavy "churning" volume and lagging breadth. Since early December strong selling has entered the market, and this persistent selling has been responsible for the churning action (churning implies heavy supply meeting heavy demand).

STOCKS Of 346 representative stocks, 217 (63%) are now above their own 30-week moving average, a drop of 8% from last week. Of the same 346 stocks, only 142 (41%) are now above their August peaks. The latter statistic is a reflection of the lagging market "breadth".

The pattern which is showing up in the majority of N.Y.S.E. charts corresponds rather closely to the rounding pattern seen in the Industrial Average. As an example, between June and September, International Paper formed a long descending triangle. The pattern broke in October, and IP plunged to a new bear market low. The rally which began in October took IP to a recovery high above its August peak. Since November, IP has been "rounding-over" along with the Industrial Average. Such patterns usually represent periods of distribution. The erratic movements of "blue-chip" IP since October, are not characteristic of bull market action.

ANNOUNCEMENT The first orders received for the Advance-Decline Ratio Albums have been shipped, and we have put in a second printing. These albums show daily A-D ratio (and Industrial) action since 1930, weekly action for the same period. I consider them to be an invaluable addition to any technical library (price $12.50). A one-page explanation prefaces the album.

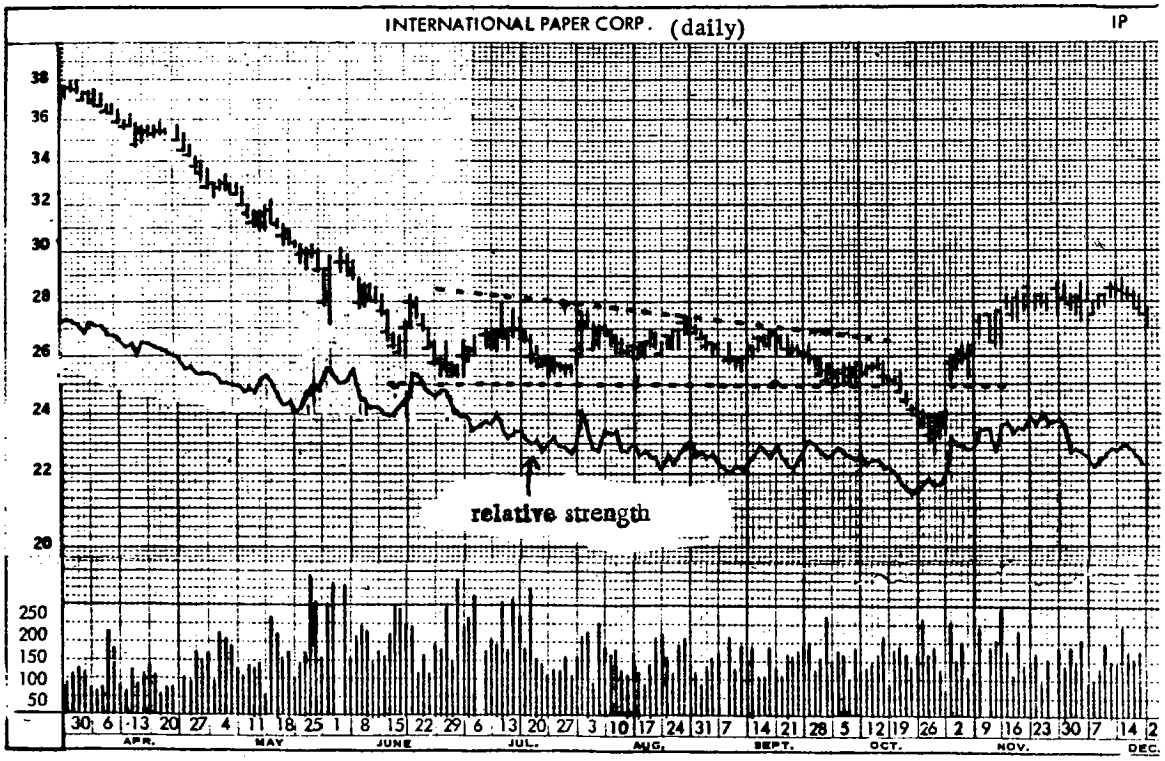


Chart of IP courtesy of Traders Research, P.O. Box 2466, St. Louis 16, Missouri.